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TORONTO, May, 2 -- Special free trade arrangements such as those accorded by the Canada-U.S. auto pact could create strong incentives for multinational corporations to manipulate transfer prices, according to a study released today by the Ontario Economic Council.

"To the extent that such manipulation is pursued or can be pursued, it results in reduced tax and/or tariff receipts, weakens the effectiveness of the tax and tariff system as an economic policy instrument, reduces employment of domestic labour and capital, and encourages the conversion of Canadian domestic firms into branches of multinational organizations," the 158 page study says.

Fiscal Transfer Pricing in Multinational Corporations, prepared by Professors G.D. Quirin and G.F. Mathewson is a study of the economic problems created by fiscal transfer pricing practices of multinational corporations and of the relevance of these problems in an international and a purely Canadian context.

Transfer prices are defined as "'internal' prices at which goods or services are exchanged between constituent parts of an organization." Prices set for such transactions, the authors add, usually have no open-market counterparts.

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"Our principal conclusion," the authors report, "is that multinationals have a relatively restricted scope for transfer price manipulation. This result stems from the fact that tax systems and tariff systems provide incentives for transfer price manipulation which tend to be mutually offsetting."

According to Quirin and Mathewson, many raw material products of agriculture, forest or mineral origin are unusually prominent candidates for transfer price manipulation because they are accorded a duty-free or low-tariff rate under Canadian and other major trading partners customs tariffs.

In its examination of industries in Canada such as agriculture, crude petroleum, natural gas, metals and ores, and pulp and paper, however, the study shows little evidence to suggest that transfer price manipulation is a serious problem.

The authors note that this "tax and tariff effect" has at least two policy implications for Canada. In the first place, in transactions where this "self-policing" mechanism is absent, such as in the area of corporate services, abuse is apt to be more prevalent. The major effect of manipulation of transfer prices in such transactions, they suggest, is a tax revenue drain which can only be partially recovered by witholding taxes.

Secondly, Quirin and Mathewson warn that free trade agreements, such as those recently advocated by the C.D. Howe Institute and the Economic Council of Canada, could result in a magnification of transfer pricing problems.

"The problem is that a corporate tax system of the North American type at present tax rates and in the absence of tariffs produces strong incentives to manipulate transfer prices in a free trade context to

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minimize tax payments. If free trade is to be contemplated seriously, it should, in our view, be accompanied by changes in the fiscal system which would remove, or at least weaken, incentives to manipulate transfer prices."

Because information on transfer pricing tends to come to light only as a consequence of litigation, the authors point out that there is a paucity of available data. Their conclusions, therefore, are necessarily hypothetical, based on numerical solutions to a series of models, the parameters of which have been varied in such a way as to cover the range of likely cases.

This study was prepared under the auspices of the Ontario Economic Council, established in 1962 as an independent public policy institute. The Council undertakes research and policy studies to encourage the optimum development of the human and material resources of Ontario and to support the advancement of all sectors of the Province. The Council achieves these goals by sponsorship of research projects, publication of studies and organization of Outlook and Issues conferences and seminars which are open to the public.

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<u>NOTE</u>: A list of persons to contact for further information, brief biographical sketches of the authors and a selection of quotations from the research study are attached.

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G. Frank Mathewson is Associate Professor of Economics at the University of Toronto and a Research Associate at the Institute for Policy Analysis at that university. He received his Bachelor of Commerce degree from the University of Toronto and his Ph.D. in Economics from Stanford University. Dr. Mathewson is the author of many scholarly articles in the field of economics and co-author of Sense and Nonsense.

Fiscal Transfer Pricing in Multinational Corporations

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SELECTED QUOTATIONS

"Transfer prices and shadow prices may be, and frequently are, set to equal prevailing market prices at which commodities are bought from or sold to third parties. While such prices are, technically speaking, 'transfer' prices in that no change in ultimate beneficial ownership takes place, it has become usual to restrict the usage of the term by considering market-based prices as 'arm's-length' prices. The term 'transfer prices' is then used to describe prices set for transaction which have no open-market counterparts. There are many such transactions, involving the sale of semifinished products, parts, or subassemblies for which no discernable market involving third parties exists, or where it exists but is disproportionately small in relation to the volume of intracorporate transactions." (Pg. 7)

"Ordinarily, as in the example cited, any international transaction between corporate affiliates will come under the (potential) scrutiny of at least three fiscal agencies, the customs officials of the importing country and the income tax officials of both countries. Where export taxes are assessed, customs officials of the exporting country may also be involved. The regulations that exist are intended, for the most part, merely to protect the integrity of the tax base and are not directed at the other economic effects which may ensue as a consequence of transfer price manipulation." (Pg. 13)

"The ambitious program of fiscal harmonization within the EEC has led to an increasing reliance on the value-added tax (VAT) and reduced emphasis on other forms of corporate taxation. Effective corporate tax rates are generally lower than in North America, not only because of lower nominal

rates but also because of more generous capital cost allowances and, in some instances at least, laxer enforcement. Given lower tax rates, the incentive to understate transfer prices on exports or to overstate them on imports is non-existent for firms involved in transactions with North — American jurisdictions." (Pgs. 20 & 21)

"One area in which transfer prices are applied has in recent years given rise to perhaps more controversy than any other. This is the area of intercorporate payments for management fees, royalties in respect of the use of patents and trademarks, sharing of research and development costs, interest and principal repayments on intercorporate loans, and other transactions that do not involve the exchange of physical commodities. Some important issues of priciple are involved in the area, as well as the more obvious tax-erosion and location-shifting questions. While such payments have been an integral part of corporate practise for decades, attention has not been focused on their transfer-pricing implications until the last decade. Pressure on U.S multinationals by U.S. authorities to increase the flow of such payments to the United States to help resolve the chronic U.S. balance of payments problem has been a major factor in highlighting this issue and creating concern in other countries, including Canada." (Pg. 67)

"Another potential area for manipulation arises because of special duty-free status with parts and finished commodities, such as auto parts moving under the special free trade accorded by the Canada-US auto pact. Because of the multiplicity of products involved and the absence of independent markets for many of them, this is probably a more difficult area to police than primary products. Where prices can be checked, such as on finished automobiles, there are price differentials, net of manufacturers sales taxes, which appear to reflect systematic price discrimination against the Canadian market and for which no satisfactory explanation

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has ever been provided. This situation is further complicated by the market power possessed by the automobile producers and by the limited access to duty-free status provided in the agreement." (Pg. 92)

"There are several important qualifications to our principal result. While the extent and effect of transfer pricing manipulation may well be less than is feared by some of the more vocal critics of multinational enterprises, and in some cases may be so small that the damage inflicted in the Canadian economy is negligible, there appears to be no conclusive proof in this area. At best, our pseudo-empirical technique is representative of a world where more complete measurement of the magnitudes appears to be impossible. Even if such proof could be produced, it would not, in our view, justify an altogether complacent attitude toward the problem." (Pg. 93)